

## Internal Revenue Service

Number: **200952018**

Release Date: 12/24/2009

Index Number: 163.00-00, 163.03-04,  
163.03-00, 163.03-02,  
163.03-03

## Department of the Treasury

Washington, DC 20224

Third Party Communication: None

Date of Communication: Not Applicable

Person To Contact:

, ID No.

Telephone Number:

Refer Reply To:

CC:ITA:B04

PLR-120138-09

Date: September 17, 2009

### Legend

Taxpayer A	=
Taxpayer B	=
Corporation W	=
Corporation X	=
Corporation Y	=
Corporation Z	=
Services	=
Year 1	=
Year 2	=
Date 1	=
Date 2	=
Date 3	=
Date 4	=
\$a	=
\$b	=
\$c	=
\$d	=
\$e	=
\$f	=
\$g	=
\$h	=
\$i	=
\$j	=
\$k	=
State	=

Dear \_\_\_\_\_ :

This letter responds to your request for a ruling that the amount that is not required to be paid on the notes should be treated as investment income for purposes of §163(d) of the Internal Revenue Code (Code).

### FACTS

Taxpayer A and Taxpayer B are married and file a joint federal income tax return using the calendar year and cash receipts and disbursements method of accounting. Taxpayer A is the president and sole shareholder of Corporation W and Corporation X. Corporation W and Corporation X are "C" corporations that provide Services. Any dividends paid by Corporation W and Corporation X to Taxpayer A would not be derived in the ordinary course of a trade or business because Taxpayer A is not a dealer or a trader in stock or securities.

Taxpayers represent that Taxpayer A is the debtor on three notes. Corporation Y holds two of the notes, and Corporation Z, a wholly owned subsidiary of Corporation Y, holds one of the notes. The notes originated in Year 1 and Year 2 to acquire the stock of Corporation W (Note 1), to make a capital contribution to Corporation W at the time of acquisition (Note 2), and to make a capital contribution to Corporation X at the time of its formation (Note 3). The notes were issued with more than a de minimis amount of original issue discount (OID).

Note 1, dated Date 1, is in the principal amount of \$a. It was issued in satisfaction of a prior note with an original principal amount of \$b. Note 1 is non-recourse and the payment of the principal and interest is secured by a pledge of Corporation W stock (but subordinate to the pledge for Note 2). The lender of Note 1 is Corporation Y.

Note 2, dated Date 2, is in the principal amount of \$c. Note 2 is non-recourse and the payment of the principal and interest is secured by a pledge of Corporation W stock. The lender of Note 2 was the predecessor of Corporation Z.

Note 3, dated Date 1, is in the principal amount of \$d. It was issued in satisfaction of a prior note with a principal amount of \$e. Note 3 is non-recourse and the payment of the principal and interest is secured by a pledge of Corporation X stock. The lender is Corporation Y.

Because of State regulatory restrictions, the lenders could not own, directly or indirectly, the stock of Corporation W or Corporation X. As an accommodation, Taxpayer A acquired and held the stock of Corporation W and Corporation X.

On Date 3, after State eliminated the restrictions on the lenders owning the stock of Corporation W and Corporation X, Taxpayer A entered into contracts to sell the stock of Corporation W and Corporation X to Corporation Z. The contract for the sale of the Corporation W stock provides that Corporation Z will pay Taxpayer A either \$f or \$g, depending on whether certain events occur. The contract allocates \$h to a covenant not to compete. Similarly, the contract for the sale of the Corporation X stock provides that Corporation Z will pay Taxpayer A either \$i or \$j, depending on the whether certain events occur. The contract allocates \$k to a covenant not to compete.

Additionally, on Date 3, Taxpayer A entered into debt payoff agreements with Corporation Y for Note 1 and Note 3, and Corporation Z for Note 2. The debt payoff agreements provide that Taxpayer A will pay the principal amounts owed of \$a on Note 1, \$c on Note 2, and \$d on Note 3. The contracts for sale of the stock of Corporation W and Corporation X provide that the principal amounts owed on Note 1, Note 2, and Note 3 will offset the amounts that Corporation Z will pay to Taxpayer A for the sale of the stock. Under the debt payoff agreements, Taxpayer A will not be required to pay the accrued interest owed from Date 4 on Note 1 and Note 3. Similarly, Taxpayer A will not be required to pay any interest on Note 2. Taxpayers state that all accrued interest owed that is not required to be paid is cancellation of indebtedness income under § 61(a)(12).

### LAW AND ANALYSIS

Section 61(a)(12) of the Code provides that gross income includes all income from whatever source derived, including income from discharge of indebtedness. See also § 1.61-12(c)(2)(ii) of the Income Tax Regulations (regulations).

Section 163(a) of the Code provides the general rule that a taxpayer can deduct all interest paid or accrued within the taxable year on indebtedness. Section 163(d)(1) limits the amount of investment interest that a taxpayer other than a corporation may deduct for any taxable year to the amount of the taxpayer's net investment income for the taxable year. Section 163(d)(2) provides that an amount not deducted by reason of § 163(d)(1) shall be treated as investment interest paid or accrued by the taxpayer in the succeeding taxable year.

Section 163(d)(4)(A) of the Code defines "net investment income" as the excess of investment income over investment expenses. Section 163(d)(4)(C) defines "investment expenses" as the deductions allowed under chapter 1 (other than for interest) that are directly connected with the production of investment income. Section 163(d)(4)(B) defines "investment income" as the sum of--

- (i) gross income from property held for investment (other than any gain taken into account under clause (ii)(I)),
- (ii) the excess (if any) of--

- (I) the net gain attributable to the disposition of property held for investment, over
- (II) the net capital gain determined by only taking into account gains and losses from dispositions of property held for investment, plus
- (iii) so much of the net capital gain referred to in clause (ii)(II) (or, if lesser, the net gain referred to in clause (ii)(I)) as the taxpayer elects to take into account under this clause.

“Investment income” includes qualified dividend income only to the extent the taxpayer elects to treat such income as investment income.

Section 163(d)(5)(A) of the Code provides that the term “property held for investment” includes (i) any property that produces income of a type described in § 469(e)(1) and (ii) any interest held by a taxpayer in an activity involving the conduct of a trade or business (I) that is not a passive activity and (II) with respect to which the taxpayer does not materially participate. The type of income described in § 469(e)(1) includes gross income from interest, dividends, annuities, or royalties not derived in the ordinary course of a trade or business. Because stock generally produces dividend income, it is property held for investment within the meaning of §§ 163(d)(5)(A) and 469(e)(1), unless the dividends are derived in the ordinary course of a trade or business. Rev. Rul. 93-68, 1993-2 C.B. 72; Russon v. Commissioner, 107 T.C. 263 (1996).

Section 1001(a) of the Code provides that the gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in ‘ 1011 for determining gain. Section 1001(b) provides that the amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received. Under ‘ 1001(c), except as otherwise provided in subtitle A, the entire amount of gain or loss, determined under ‘ 1001, on the sale or exchange of property shall be recognized.

Section 1.1001-2(a) of the regulations provides that the amount realized on the sale or other disposition of property includes the amount of liabilities from which the transferor is discharged as a result of the sale or disposition.

## CONCLUSION

Based on the facts presented and the representations made, we conclude that if the amount that is not required to be paid under the debt payoff agreements is properly characterized as accrued unpaid interest and treated as income from discharge of indebtedness under § 61(a)(12), then the income should be treated as investment income for purposes of § 163(d). We further conclude that, if the amount owed that is not required to be paid under the debt payoff agreements is properly characterized as an additional amount realized upon sale of the stock under § 1001 and the regulations, then any additional gain is gain attributable to the disposition of property held for investment and is covered by the provisions of § 163(d)(4)(B)(ii) and (iii). If the amount

that is not required to be paid under the debt payoff agreements is properly characterized as income other than income from discharge of indebtedness or an additional amount realized upon sale of the stock, we express no opinion concerning its treatment for purposes of § 163(d).

Except as expressly provided, we express or imply no opinion concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. Specifically, we express no opinion as to whether the amount owed that is not required to be paid is principal and, therefore, an additional amount realized under §1001 and the regulations, or accrued unpaid interest. Further, we express no opinion as to whether any accrued interest owed that is not required to be paid should be characterized as income from discharge of indebtedness under § 61(a)(12) or as a medium of payment of an additional amount realized on the sale of the stock under §1001 or other type of income.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

A copy of this letter must be attached to any income tax return to which it is relevant. Alternatively, taxpayers filing their returns electronically may satisfy this requirement by attaching a statement to their return that provides the date and control number of the letter ruling.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Sincerely,

Donna Welsh  
Senior Technician Reviewer, Branch 4  
Office of Associate Chief Counsel  
(Income Tax & Accounting)